



# Investment Views



December 2021

Global Strategy

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# Global Strategy

## Tapering and Variants

November tends to be the time when people start to think about the year ahead and investment banks write their research pieces detailing their views on the investment outlook. The issue with this of course is that new risks can present themselves before we reach the end of December; the Omicron variant is one such example.

If you tune out all the noise surrounding financial markets and economic conditions, the fundamental problem over the past 20 months has been the global health crisis. Many of the market dynamics seen throughout this year can be traced back to the Delta variant, which delayed the global economic reopening and, at the same time, deferred the shift in consumer spending to services from goods. Instead, the continued elevated level of spending on goods happened against a backdrop of global supply chains struggling to keep up with demand while also navigating social distancing and temporary closures; this caused bottlenecks in the global production and logistics system.

*Many of the market dynamics seen throughout this year can be traced back to the Delta variant.*

There has been some debate around whether the pandemic crash and recovery was the start of a new economic cycle or whether the vast and swift policy response essentially “froze” the last cycle in place. This is an important starting point for thinking about the year ahead because, as the saying goes, if you want to know where you are going, it helps to know where you have been. However, the challenge is the extent of the dispersion caused by the COVID-19 shock. Some sectors were beneficiaries of people staying at home and suffered no slowdown; in some instances, business actually boomed. Whereas for other industries at the sharp end of social distancing measures, there was a depression and economic activity temporarily went to zero.

Looking at aggregates is always challenging but it is particularly problematic this cycle because of this underlying dispersion, which is quite different to the comparatively low economic volatility seen in the last cycle. In the prior cycle, the services side of the economy grew consistently with little volatility, whereas the manufacturing cycle was more volatile and the marginal driver of cyclical activity.





However, the pandemic has caused huge volatility in the services sector - travel and leisure being at the forefront – so the backdrop now is very different to the decade prior to the onset of the pandemic.

The unique nature of the pandemic shock has made traditional business cycle analysis very difficult. Furthermore, the level of government support provided to the economy means that many sectors didn't really experience a recession in the traditional sense at all. However, one of the challenges we have now that is very different to the recovery from the Global Financial Crisis is the inflation backdrop. The inflation scare in 2010-2011 proved transitory with the eurozone's two interest rate rises being a costly error. This time around, there is a much more legitimate debate. Central banks now find themselves with a communication challenge as they start to unwind the stimulus measures that have been in place for almost two years.

While the big picture is that the return to normality has been delayed rather than postponed, the combination of the uncertainty around the Omicron variant together with central banks tapering their assets purchases and considering raising interest rates presents challenges. We continue to watch both closely as the virus situation poses a risk to the real economy and tighter monetary policy poses a risk to financial markets. The big risk is that central banks tighten aggressively into a new wave of virus-induced economic weakness. While this risk has risen recently, flexibility and pragmatism should continue to prevail.

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# Fixed Income

## Market Tremors

Many large earthquakes are preceded by smaller rumbles known as foreshocks. However, there is no way to distinguish these tremors from other small quakes that don't portend a larger temblor. At the same time, many large earthquakes do not seem to have any foreshocks. A seismology reference but entirely relevant to the events in markets over the past month.

Volatility has spiked across multiple asset classes with the broad commodity index down -7.3%, led by declines in oil (-21%) and natural gas (-16%), global government bond yields and the US dollar rallying and evidence that hedging is taking place in credit and equity markets as high yield CDS spreads and the VIX reached their highest levels since March. The impact of monetary tightening by the Federal Reserve cannot be underestimated and largely explains this uptick in volatility during November as the US central bank officially started to taper their balance sheet.

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As expected, purchases will be scaled back by US\$10bn per month in US Treasuries and US\$5bn in US mortgage backed securities but in a more hawkish tilt the taper started immediately and optionality was introduced so the pace could be accelerated in coming meetings if inflation remains elevated.

With sentiment turning negative last month, economic data across the major economies managed to surprise the bearish forecasts to the upside, but in absolute terms continued its weakening trend. However, with financial conditions still ultra-easy and the Atlanta Fed GDPNow forecast expecting a fourth quarter US growth rate of +8.6%, we refrain from leaning too dovish at this point. The "shadow" federal funds rate (which incorporates quantitative easing) as measured by Wu Xia indicates short-term interest rates are currently still deeply negative at -1.7%. Although, actions by the Federal Reserve to reduce asset purchases will pull this shadow rate to the official base rate of 0.25% potentially over the next six months, this would tighten monetary policy by 195bps and at its fastest clip since 2014. This makes us nervous; however, if this causes volatility, it will present an opportunity for actively managed conservative portfolios.





Over in Europe, the combination of rising virus cases and rising energy prices is presenting a challenge for consumer spending. Restrictions are being reimposed in some countries and economic activity looks likely to suffer in the run up to the crucial Christmas period. Given the high vaccination rate in Western Europe this caught markets slightly off guard, with COVID-19 viewed as a minor risk to the outlook in Europe and a risk that isn't even mentioned in the US anymore.

Clearly a mass re-opening of the global economy will be off the agenda for some time yet and therefore global growth in 2022 is likely to be revised downward in coming months. This also makes the current path the Federal Reserve is on dangerous to a degree and significantly raises the probability of a policy error over the coming months – Fixed Income markets certainly believe this given the rally in long bonds which is at odds with the current inflation and government bond supply outlook.

Warren Buffet once said: “Look at market fluctuations as your friend rather than your enemy; profit from folly rather than participate in it.” This quote is foremost in our minds

as the Federal Reserve attempts to withdraw policy support. Our current positioning reflects the high levels of uncertainty over the outlook for the next three months. For short dated portfolios, with three year US Treasury yields currently at 0.84%, the market is already pricing five 25bps base rate hikes by 2024 with lift off in July 2022. This is an attractive valuation point to remain neutral duration.

Longer dated portfolios face a 10 year US Treasury yield which isn't cheap at 1.45% versus slowing growth, rising geopolitical risks and a likely increase in risk asset volatility. Given that backdrop, we remain close to neutral duration for now and favour the ballast US Treasuries provide during low liquidity periods such as the coming holidays but will monitor the market for signs of short positioning capitulation and/or signs of a rebound in global economic growth.

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# Equities

## Volatility is Back

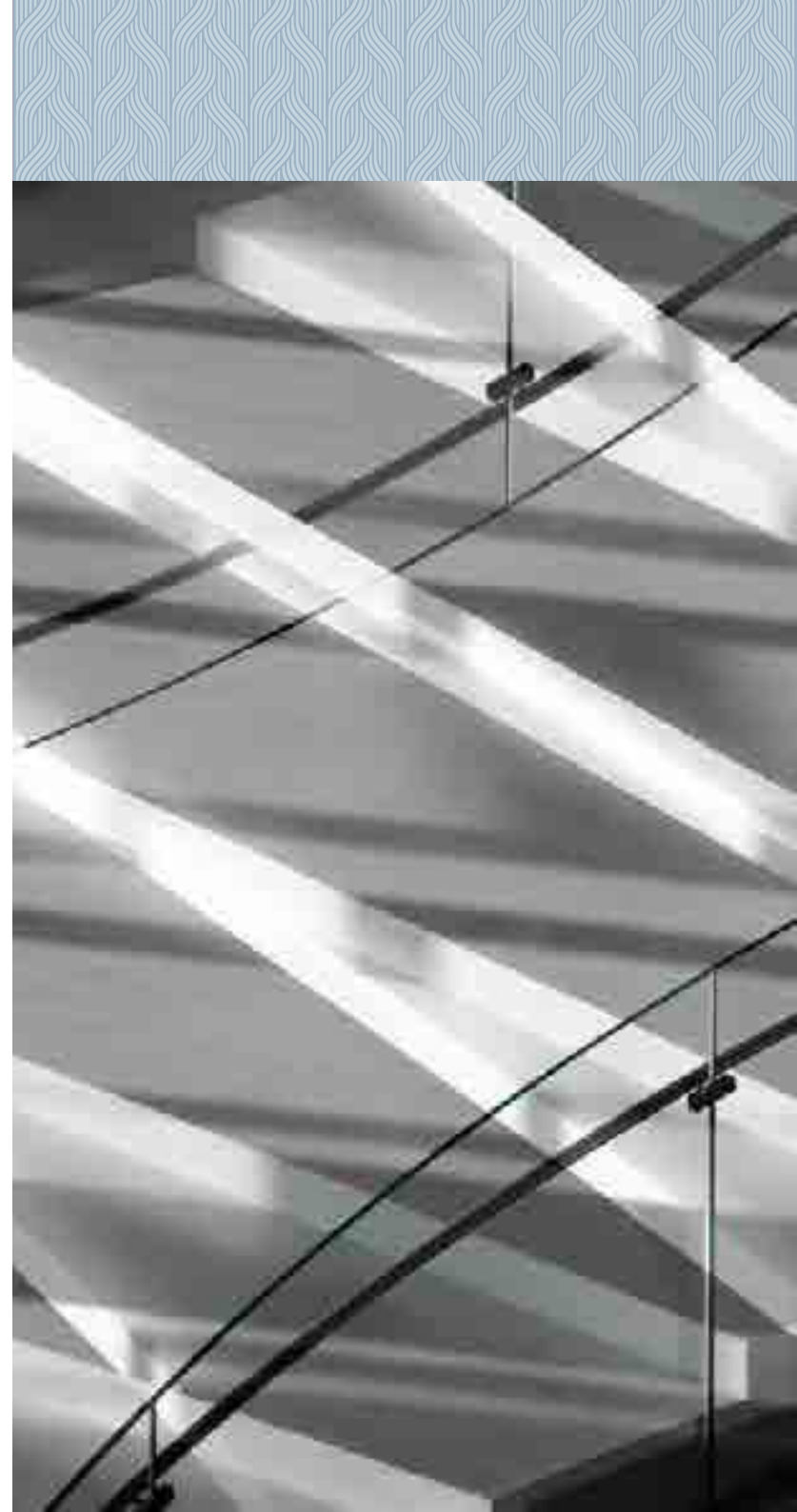
Equity markets were volatile in November, with the MSCI World Index gaining +2.0% in the first week before finishing the month down -2.2% in US dollar terms. Signs of growth in the US rebounding after a weak third quarter were overrun by increasing concerns about the emergence of the significantly mutated Omicron variant, combined with Fed comments indicating tapering may be accelerated and inflation may remain elevated for longer.

The potential negative impacts on economic growth triggered a sell-off in equity markets and repositioning into companies which might perform better in a more Covid-wary environment. For the full month of November the only sector with positive return was Information Technology (+2.6%), fueled by industry heavyweights Apple (+10.5%) and chipmaker Nvidia (+27.8%). Sectors which declined most include energy (-6.7%), financials (-6.3%), communication services (-4.8%), health care (-3.5%) and industrials (-3.9%).

*The potential negative impacts on economic growth triggered a sell-off in equity markets...*

Developed markets outperformed emerging (-4.1%), led again by the US market where the S&P 500 declined only -0.7%. The US market's relative stability over the full month of November masks intra-month gyrations also experienced in the S&P 500, which had returns that were 3% higher just one week prior. Market volatility has remained relatively low this year, so it is unsurprising that volatility has picked up in the final quarter of the year. There has been more volatility at the individual stock level under the headline indices of equity markets; according to Morgan Stanley the median S&P 500 stock has corrected 15% from its 52-week high, but the index has been kept aloft by the 15 largest companies now accounting for 40% of its market capitalisation.

These equity market swings have proved challenging for active equity fund managers, with just 32% of large cap mutual funds outperforming their respective style benchmarks year to date (21% of core, 16% of growth, and 63% of value funds). Fundamental equity long/short hedge funds fared no better, with the typical fund posting a flat year-to-date return compared with +23% for the S&P 500 according to Goldman Sachs.





The theme of the pandemic causing a large dispersion between different sectors and companies should have been a positive for active stock pickers, but the stop-start nature of the recovery together with the outperformance of the mega-cap stocks has made for a very challenging environment.

One of the driving forces of the market rally this year has been the strength of the inflows from retail investors. According to analysts at Bank of America and EPFR Global, investors have poured almost \$900 billion into equity exchange-traded and long-only funds in 2021. This sum exceeds the combined total from the past 19 years. Furthermore, this sum exceeded anything else this year, with bond funds attracting \$496 billion and money market funds receiving about \$260 billion.

These inflows have helped the market bounce back from short-term dips and this marks a notable change from the period prior to the pandemic when retail investors were less active in the equity market. A period of pronounced volatility would certainly test this mindset, but corporate earnings help underpin the market.

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